

Message Text

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DRAFTED BY EA/IMS:ARDORNHEIM:CCH
APPROVED BY EA/IMS:EDWARD C. INGRAHAM
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TO AMEMBASSY JAKARTA

C O N F I D E N T I A L STATE 057348

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E.O. 11652: GDS

TAGS: ENRG, EFIN, ID

SUBJECT: IRS AND INDONESIAN PRODUCTION-SHARING CONTRACTS

REF: A. JAKARTA 2968 B. JAKARTA 2509

1. WHILE IT IS ENCOURAGING TO READ REFTEL A, RESOLUTION OF INCOME CONSOLIDATION ISSUE WITH IRS DOES NOT PROMISE TO BE EASY. STAND THAT IRS HAS TAKEN IS MOTIVATED NOT BY ANY HOSTILITY TOWARDS INDONESIA BUT BY STATED IRS DESIRE TO ENSURE THAT U.S. OIL COMPANIES ARE TREATED BY FOREIGN GOVERNMENTS FOR TAX PURPOSES ON SAME STANDARD OF FAIRNESS AS THEY ARE TREATED BY USG.

2. AS WE UNDERSTAND IT FROM CONVERSATIONS WITH IRS OFFICIALS, RATIONALE BEHIND IRS JULY 14, 1976 GUIDELINE IS THIS. ITS INSISTENCE THAT "APPROPRIATE ROYALTY" PAYMENT TO HOST GOVERNMENT BE SHOWN FIRST BY U.S. TAXPAYER
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IS DESIGNED TO ENSURE THAT HOST GOVERNMENT RECEIVES A FAIR RETURN ON SUCCESSFUL EXTRACTIONS OF MINERALS IT OWNS, ONE THAT IS "COMMENSURATE WITH VALUE" OF A PROVEN OPERATING AREA. ONCE THIS RIGHT TO AN APPROPRIATE ROYALTY HAS BEEN SATISFIED, IRS BELIEVES THAT U.S. AND OTHER FOREIGN EXTRACTORS OF MINERALS SHOULD THEN BE TAXED ONLY ON THEIR NET GAIN FROM ALL OPERATIONS IN COUNTRY. FOR

INCOME TAX PURPOSES, FOREIGN EXTRACTORS SHOULD HAVE CHANCE TO OFFSET COST OF ALL THEIR FAILURES IN A COUNTRY AGAINST REVENUES FROM THEIR SUCCESSES IN SAME COUNTRY. IRS HOLDS THAT TO DENY EXTRACTORS RIGHT TO CONSOLIDATE THEIR GAINS AND LOSSES WOULD BE TO REQUIRE AN UNREALISTIC AND UNFAIR TAX ACCOUNTING FOR TOTAL ECONOMIC ENTERPRISE OF A PARTICULAR EXTRACTOR COMPANY IN COUNTRY CONCERNED. IRS BELIEVES THAT INCOME TAX SHOULD BE ADMINISTERED BY FOREIGN GOVERNMENT IN A WAY WHICH WILL ENSURE THAT ONLY NET GAIN IS TAXED, JUST AS IRS SEEKS TO DO WITH RESPECT TO OPERATIONS OF OIL COMPANIES WITHIN US. IN IRS VIEW, GOI IS NOT TRYING TO "REACH NET GAIN" BUT IS SEEKING TO MAXIMIZE REVENUE BY REFUSING TO PERMIT ANY EXTRANEIOUS (EX-CONTRACT AREA) OFFSETS AGAINST REVENUES FROM A GIVEN CONTRACT AREA. FOREGOING CONCEPTS SEEM TO BE STRONGLY HELD BY IRS AND IT WILL NOT BE EASY TO MODIFY THEM.

3. JULY 14, 1976 GUIDELINES ALSO SERVED AS OPPORTUNITY FOR IRS AND TREASURY TO MODIFY U.S. TAX POLICY WHICH HAD PERMITTED AN INDIRECT TRANSFER OF RESOURCES TO STRATEGICALLY IMPORTANT OIL-PRODUCING COUNTRIES BY ALLOWING LATTER TO KEEP MAJOR SHARE OF TAXES PAID BY U.S. OIL COMPANIES THROUGH RELATIVELY LIBERAL U.S. TAX CREDITABILITY FOR FOREIGN INCOME TAXES. MOBIL'S REQUEST FOR A RULING ON ONE OF ITS PRODUCTION-SHARING CONTRACTS WITH PERTAMINA PROVIDED IRS AND TREASURY WITH OPPORTUNITY TO REVISE TWO-DECADE-OLD POLICY, WHICH WAS SEEN TO BE NO LONGER SUPPORTABLE POLITICALLY, BECAUSE OIL-PRODUCING COUNTRIES

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HAD NO FURTHER NEED OF RESOURCE TRANSFERS.

4. WHATEVER THE MERITS OF IRS POSITION, IT IS UNWARRANTED (AS FISHER AND OIL COMPANY TAX LAWYERS TOLD PERTAMINA AND GOI OFFICIALS) TO CONCLUDE THAT IRS GUIDELINES ARE AIMED SOLELY AND VINDICTIVELY AT INDONESIA OR THAT IRS HAS ULTERIOR MOTIVE OF IMPROVING FINANCIAL POSITION OF U.S. OIL COMPANIES. AS NOTED ABOVE, ULTERIOR MOTIVE, IF ANY, IS IRS DESIRE TO MAXIMIZE USG "TAKE" FROM OIL COMPANIES. NOR IS THERE MUCH LIKELIHOOD THAT IRS WILL RECOGNIZE MORAL OBLIGATION TO MAKE AN EXCEPTION TO ITS GENERAL TAX CONCEPTS IN CASE OF INDONESIA OR TO "SHOW GOOD FAITH", SIMPLY BECAUSE GOI HAS "DONE ITS PART" BY MAKING SUBSTANTIAL ALTERATION IN CONTRACTS TO MEET ORIGINAL IRS CONCERNS ABOUT TAX PAYMENT PROCEDURES AND QUESTION OF ECONOMIC INTEREST. THIS TOUGH ATTITUDE NOTWITHSTANDING, IRS IS NOW FULLY AWARE OF INTENSE GOI INTEREST IN WHOLE SUBJECT OF U.S. TAX CREDITABILITY FOR U.S. EXTRACTIVE COMPANIES OPERATING ABROAD. FAIR TO SAY THAT SUBJECT IS NO LONGER

SEEN AS "SIMPLE TAX MATTER".

5. ABOVE MAY BE HELPFUL TO EMBOFFS IN THEIR FUTURE DISCUSSIONS WITH PERTAMINA AND GOI OFFICIALS. OCCURS TO US THAT WHEN EMBASSY IS INFORMED MINISTRY FINANCE HAS AUTHORIZED ROGERS AND WELLS TO DISTRIBUTE "DRAFT" TAX DECREE TO OIL COMPANIES, IT MIGHT INCLUDE IN ITS TELEGRAM REPORTING THIS DEVELOPMENT (FOR GENERAL DISTRIBUTION TO WASHINGTON AGENCIES) SOME BACKGROUND COMMENTARY ON FACTORS WHICH MOTIVATED GOI WHEN IT ESTABLISHED PRODUCTION-SHARING SYSTEM. AS WE UNDERSTAND IT, THIS SYSTEM, WITH ITS CONCEPT OF SEPARATE CONTRACT AREAS, LIBERAL COST RECOVERY AND INITIAL 35 PERCENT SHARING FORMULA, WAS NOT DEvised TO MAXIMIZE TAXES BUT RATHER TO MAXIMIZE INCENTIVES FOR FOREIGN OIL COMPANIES TO ACCEPT RISKS OF EXPLORATION. SUKARNO ERA EXCESSES WERE FRESH IN MINDS OF OIL COMPANIES, AND GOI HAD TO GO TO CONSIDERABLE CONFIDENTIAL

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LENGTHS TO INDUCE THEM TO RESUME OPERATIONS IN INDONESIA; MAXIMIZING TAX "TAKE" WAS NOT TOP PRIORITY FOR GOI AT THAT TIME. MOREOVER, PRICE OF OIL IN MID-1960S, WHEN PRODUCTION-SHARING CONCEPT WAS REFINED, WAS MUCH LOWER THAN IT IS NOW AND ALSO MUCH MORE UNDER CONTROL OF OIL COMPANIES THEMSELVES.
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